DOW THEORY LETTERS INC.

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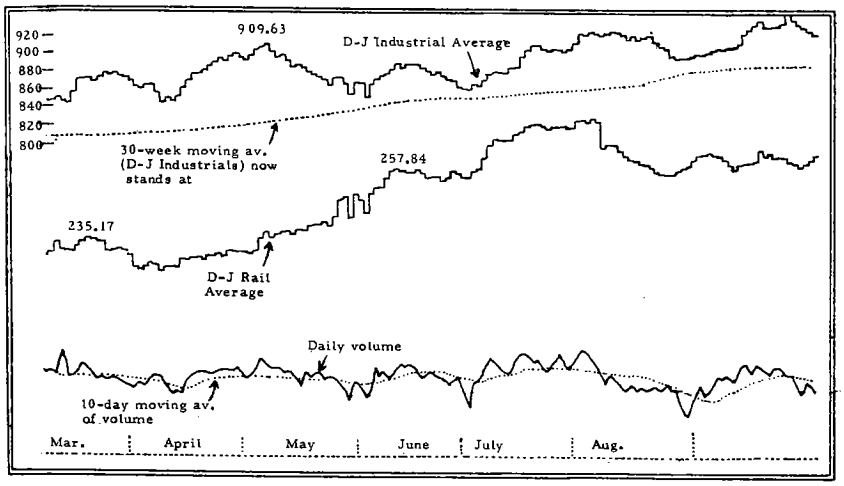
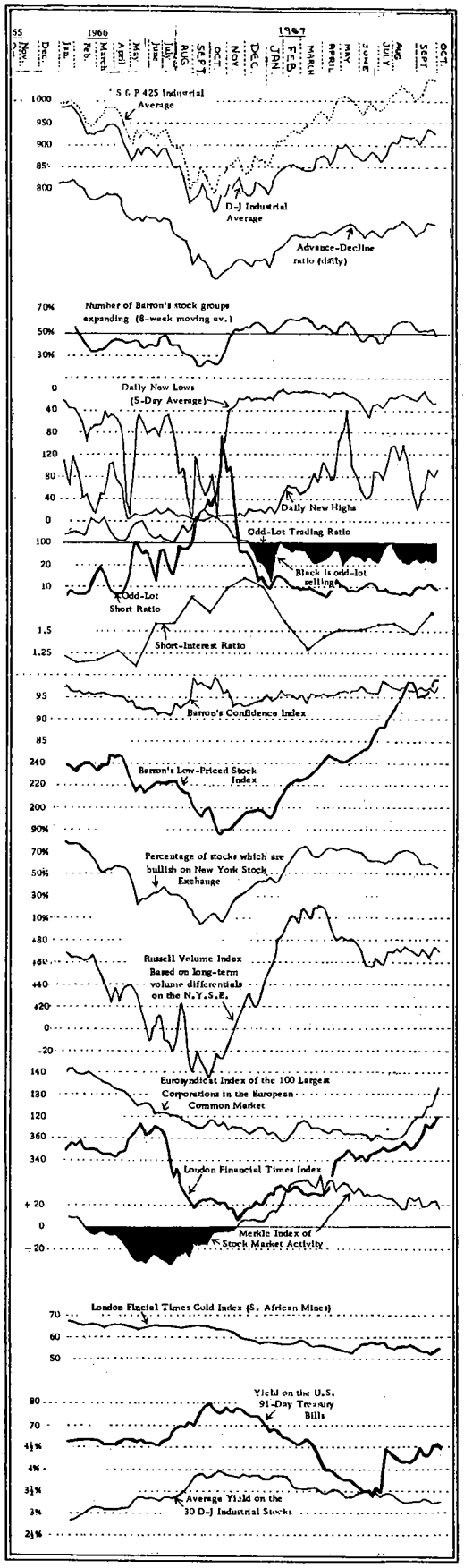
THE MARKET: There is a subtle change creeping into today's market thinking. The change is centered mainly with the bearish element. Those who have been looking to 1967 for the final crack-up of the post World War II bull market are now putting the trouble ahead— to 1968. For the most part they have written off 1967 as the potential period of major collapse. Many are of the opinion that President Johnson's Administration will allow any amount of speculation and inflation rather than put the brakes on the market and the economy. With the election coming up in late-1968, claim the cynics, the Administration will do all in their power (and this means avoiding any political or financial "unpleasantness") in order to sidestep the mess which is simmering in every sector of the economy and the social fabric and political structure of the nation.

One veteran, widely-read economic advisor wrote last week: "We are the victims, currently, of probably the most massive economic brain-washing that any administration has ever launched against the public sector. We are being convinced that the expenses of Vietnam are the cause of the horrible red ink facing our budget when, in actuality, the war has been responsible for only one-fourth the gain in Government expenses since 1960 and, in the past 7 years, civilian outlays have risen almost 50% more rapidly than military spending and 8 times faster than the population itself."

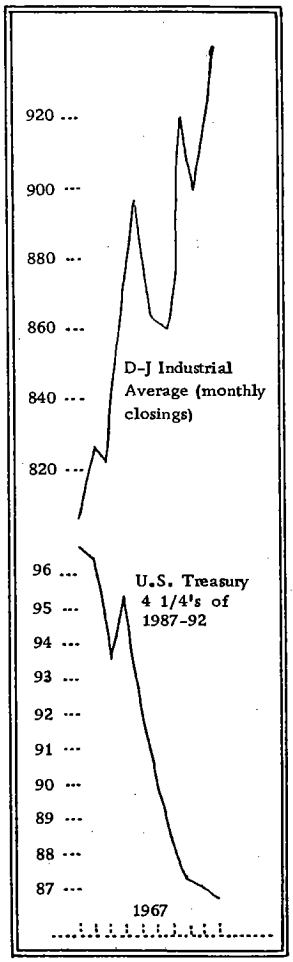
In my opinion, the longer this fantastic counter-primary trend rally lasts, the greater and longer will be the ultimate period of reckoning. Already, this inflation-inspired, pump-primed advance has far overstayed the time which can be considered "normal" for a correction of the 1966 bear-market decline. The longer and higher the rally goes, the greater will be the ensuing smash and the longer the expected period of decline.

Meanwhile, the relentless, crushing action in the bond sector of the financial market continues. All segments of the nation's debt structure, from the short-term 91-day Treasury bills to the long-term Treasury bonds have been sinking to new lows (and new highs in yields). The yield advantage to investors in bonds is so overwhelming that there is no other conclusion than to state that the equity markets are in a frantically speculative state. The obvious rationale for all this intense speculation is based on inflation. Price increases




S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

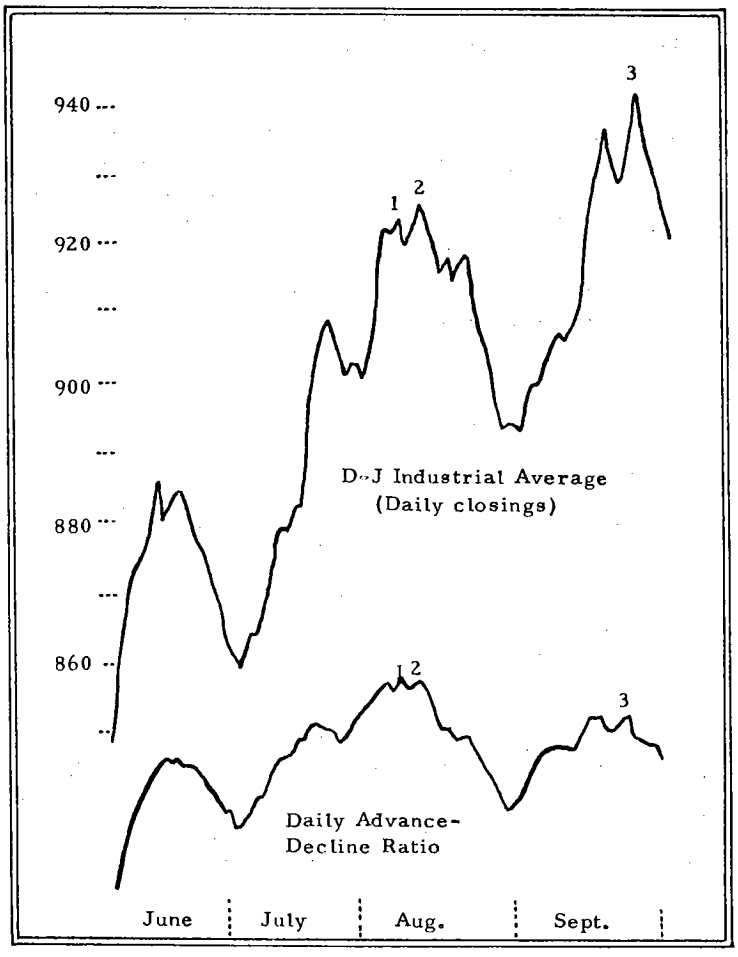
are springing up in all directions, wage hikes are being demanded, and the public is sinking into a state of inflationary euphoria. Saving is looked upon as some sort of primitive stupidity, while those who go into debt are "with it," and are taking shrewd advantage of the tides and the times. The great illusion of eternal prosperity has captured the imagination of a dream-prone public, and today's market is a reflection of that state of mind.



I have included a rather dramatic chart which I believe illustrates the great dilemma of the investment markets today. Here we see the monthly closings of the blue-chip D-J Industrial Average for 1967 superimposed upon the monthly closing of the bellwether of the long-term Treasury bond market, the $4\frac{1}{4}$'s of 1987-92. While the Dow has climbed from roughly 809 to the mid-940's during 1967, the $4\frac{1}{4}$ bonds have collapsed from 97 to an historic low of 86. During that period the yield on the Dow has declined from a January high of 3.72% to this week's low of 3.22%. Over the same period the yield on the $4\frac{1}{4}$'s has risen from the January level of 4.51% to this week's high of 5.20%. Thus, the yield advantage is now 1.98% in favor of the Treasuries, generally considered to be the safest investment in the world today. Furthermore, those purchasing the Treasuries at today's deep discount price of 86 are guaranteed a capital gain of 14 points if they hold their bonds to maturity. Against this, all dividends collected on the Dow stocks are considered income and subject to full taxes. The dilemma to informed investors is clear, and the strain in the investment markets is increasing. In the vernacular, "something's got to give."

Turning to the technical condition of the market, the Rail Average produced an obvious non-confirmation during the most recent rise (see page 1 chart), failing by a wide margin to better its August 4th high of 276.24. The Industrial Average, of course, advanced to new recovery highs. The high for the Rail Average was reached on September 18 at 265.11. Then, despite a further Industrial push the carrier index commenced to diverge, declining in the face of the continuing Industrial advance. This divergence proved too much for the market, and on September 27 (following the non-confirmation and divergence) the entire market sold off. More recently, the divergence has continued, with both Averages "out of gear" and seemingly unable to get together. This type of action is frequently indicative of a top forming.

I have included a chart showing the path of the advance-decline ratio and the Industrial Average since June. I previously brought to the attention of subscribers the little non-confirmation in August, during which time Industrials pushed to a new high (point 2 on chart) unconfirmed by the Rail Average. A sell-off ensued, but in late-August the market started up again. Here, the advance-decline ratio failed by a wide margin to confirm the new recovery peaks in the senior Average (point 3 on chart). This sets up a rather dangerous situation with two consecutive instances in which breadth refused to confirm price. The question now is whether the increasing technical weakness as shown in both the Rail non-confirmation and the series of breadth non-confirmations will be followed by definite and persistent downside action.



So far, all indications of weakness in this market have been very subtle in character. For instance, on upside days the pleurality of advances over declines has been slight. But on downside days declines have outnumbered advances by a rather large margin. This is subtle weakness during up-days, further but slightly more obvious weakness during down-days.

The Russell long-term volume index (page 1) is still not showing real strength, having topped many weeks ago. This week (see composite page 1 chart) the percentage of Barron's stock groups advancing (8-week moving average) dropped to 48%, just under the critical 50% level. The most encouraging factor to the bulls over the past month has been the contraction of daily volume on down-days, and the expansion of volume on rallies. But I warn readers that volume characteristics can be very deceptive during the early stages of a decline. Most major declines (almost all, in fact) have started on low volume.

CONCLUSION: The ingredients of technical weakness are now present in this market, and they are increasing. I feel that a major top is in the process of formation, although it could take until late-October or November to be completed. Remember that most major declines occur in the face of published good news. The market has already risen for a year in the way of discounting much good news, and it may not respond to the actual publication of further happy tidings. This is a time to play it safe if for no other reason than that speculation has been rife during this entire advance. Every speculative market edifice in history has ultimately collapsed. This one has already far over-extended itself. It's time will come. In my opinion, that time is near.

REPORTS FROM ALL POINTS: With the U.S. gold ratio down to 30.9 and the legal limit 25%, the Administration is readying the propaganda to remove all gold backing from U.S. currency. Noting this, my friends at Indicator Digest write: "If you agree with us that removal of the gold backing is now inescapable, then you also know what the consequences will be. If you think we are experiencing inflation now, you haven't seen anything yet. When the 25% limitation is removed, it will automatically unlock the last bolt on the gates of inflation and you are quite likely to see the wildest inflationary orgy in U.S. monetary history." Later they add, "When the bars are removed, all fiscal discipline will vanish, as new U.S. bond issues (which eventually become monetized) are created out of thin air to meet the Government's deficit. We will then be on a pure fiat paper money standard, unleashing the same sort of unrestrained inflation that crippled the currencies of France and Germany back in the '20's."

From abroad, economist Eliot Janeway writes about the Swiss view: "Confrontation with the prognosis of an indefinite prolongation of the war invariably produces the most emphatic bearish reactions— all the way from the intangibles of world politics to the brass tacks about the dollar. An inconsistency is involved: inflation in America is accepted as the basis for bullishness about Wall Street. But the war is at the root of inflation, and the war is accepted as forcing a bearish stance toward the stock market— that is, 'if it isn't ended' (as of course it isn't about to be). The big question is how long the bullishness of inflation on the stock market will buck the bearishness about the actual impact of the war on the dollar economy."

From the Babson Washington Forecast Letter (Oct. 2): "If the New Economy requires that we maintain inflation without end in order to avoid economic upsets and preserve full employment, the dangers are increased that our economy may get out of step with our sister nations of the West.....especially since we, thru our dollar, have been furnishing liquidity to most of the countries of the Free World. At the same time, we have been forced to spend heavily abroad in wars and economic and political advancement. The net result has been a permanent condition of imbalance in our international payments.

"It is not imminent, perhaps, but surely the danger does exist that at some future time we may be forced to alter our policy of perpetual inflation in order to maintain our position among the other nations of the Free World. Eventually, it may be discovered that we are no more isolated in our economic systems than we have been in our international political relationships."

SURTAX MESS: The biggest political football in the country today is the proposed surtax. Our Government wants "more," but nobody wants to pay for it. Those who thought the surtax was in the bag for 1967 have about given up. According to economist-writer Eliot Janeway (Sept. 20), "The smart hard core of the Republican leadership in the House— and it exists; it functions; and, increasingly, it has its way— is calculating that the time to give LBJ his surtax will be in the spring of 1968, when it hurts him the most."

Without the surtax, the coming budget deficit promises to be mountainous. The bond markets know it, and it is protecting itself from the fiasco— by sinking to fresh new lows each week. But the public is almost totally unaware of the giant money market, and the bond market's agony (so far) has fallen on deaf ears.

"The frenzy with which Congress is now searching for some other answer to the country's economic dilemma," notes the Sept. 23 London Economist, "would be comical if it did not, at the same time, involve problems of such deadly seriousness..... Congress is searching for an answer that would be politically easier than raising taxes and various members have three alternatives in mind— none of which is easy at all."

The first alternative is to cut Government expenditures, but everyone wants to cut the other fellow's appropriations, and there is little hope here of anything serious being done. The second alternative is to "reform" the tax laws so that money may be extracted from those who are currently considered to be paying less than their fair share. Here the problem is that any tax reform is calculated to produce little real income for the Government. If every single loophole in the current tax law were to be closed, it is calculated that the total take would be around $5 billion. The chances of any true reform along these lines is probably nil.

 The final alternative to the surtax is to do nothing. This path (and it is a possibility) is the one that economists almost in unison consider to be the road to a "financial chamber of horrors." So the stock market is protecting itself against inflation and the "do nothing" school by rising, the bond market is protecting itself against the same school by declining, and the politicians are protecting themselves by talking out of all sides of their respective mouths. The final story has yet to be told.

GOLD: The battle lines are becoming painfully clear as the IMF meeting in Rio de progresses. The big surprise (to the U.S.) was the hardening of the German position in favor of France. During the early days of the meeting Karl Schiller, West German Economics Minister, stated that Germany views the entire "reform resolution" as a single package in which the Special Drawing Rights should be lumped together with veto rights on the part of the Common Market nations. Up to this time, the U.S. alone has been entitled to exercise veto rights at the IMF, but in August the U.S. agreed in its reform proposition to turn veto rights over to the Common Market nations in return for concessions on monetary reform.

On the second day of the Rio conference the French Economics Minister, Michael Debre, virtually sank the whole SDR and "paper gold" concept. He demanded that no SDR's be issued until the U.S. completely ends its long string of balance-of-payments deficits. This is tantamount to saying that France will favor SDR's when oranges are grown in Alaska. With Germany and France leading the Common Market, and with the Common Market exercising a veto position over the IMF, the great paper gold argument is on its way "down the tubes."

In reaction to the IMF developments, the gold shares rallied sharply last week. But in actuality, no one should have been surprised by the turn of events at Rio. France and Germany between them own more than $11 billion of gold (almost as much as the U.S.); yet their gold is not in hock. It is used as backing for their currency. In other words, France and Germany currently enjoy a "long" position in gold. Why should they favor a system which favors inflation and the "have-not" countries? As far as gold is concerned, the U.S. is now literally a have-not country, and as such its monetary policies are fast approaching those of the "banana republics." The U.S. wants to print money, and it does not want the restrictions of gold put upon it.

So the picture is one of the poor countries and the gold-hungry spendthrift nations opposing the gold-rich nations. In all history, the nations which were powerful enough to hoard gold have come out dictating terms to those nations which were losing gold. This writer is betting that history will repeat. Already, we see the Common Market nations dictating terms to the U.S. in the form of IMF rules and concessions. "Gold will win," runs the time-honored economic adage. I believe it will again. Those nations who hold gold are like individuals who hold large blocks of stock. They want to see the price of their commodity rise. This is the position of the Common Market. The drama is unfolding now, and I continue to suggest that all my subscribers retain their hedge position of 10% to 15% of assets in selected gold shares.

APOLOGIES: In Letter 368 I ran a chart of Free Reserves. I did not give credit to Merrill Analysis, Box 228, Chappagua, N.Y. 10514. In Letter 370 I ran charts of GM and Telephone without giving credit to Quote Digest, 110 Lorraine, Wichita, Kansas.

CHART OF THE WEEK: Here is another excellent Merrill Analysis chart showing 1967's dangerous negative spread between the average yield on the 30 Dow Industrials and Barron's 10 Highest-Grade Bonds. The spread is now the highest in history. The rationale again is inflation, the willingness of the average investor to pay an exorbitant amount for common stocks in the face of the highest bond yields in 40 years. In this type of atmosphere, it goes without saying that the informed investor would be going against "the accepted viewpoint." This would mean moving out of common stocks and into bonds which, on the basis of all history, are on the bargain table. Obviously, exact timing in this type of operation is not necessary. The odds say that sometime within the next two or three years the holder of bonds is going to be dead right, the holder of common stocks dead wrong. It should be remembered that the true investor makes his money through patience and judgment of values. The speculator makes his money on his appraisal of short-term trends.